

**Office of Chief Counsel
Internal Revenue Service**

memorandum

CC:TEGE:EOEG:CELivingston

date: November 20, 2008

to: Robert Erickson
Tax Forms & Publications

from: Catherine E. Livingston
Deputy Division Counsel/Deputy Associate Chief Counsel, (Exempt
Organizations/Employment Tax/Government Entities)
(Tax Exempt & Government Entities)

subject: Offset Provision Applicable to Credit Under Section 45P

Tax Forms & Publications requested legal advice with respect to how to apply the offset provision of newly enacted section 45P that requires that certain other tax credits be reduced by the amount of the section 45P credit.

Section 111 of the Heroes Earnings Assistance and Relief Tax Act of 2008, Pub. L. No. 110-245 ("HEART Act " or "Act") adds section 45P to the Code. Section 45P provides a credit to eligible small businesses that make differential wage payments to qualified employees who are on active duty in the uniformed services for more than 30 days. An eligible employer may take a credit against its income tax liability in an amount equal to 20 percent of the sum of the differential wage payments made for employees during the taxable year. The definition of differential wage payments for purposes of the section 45P credit is the same definition enacted in new section 3401(h). A differential wage payment is any payment which (1) is made by an employer to an individual with respect to any period during which the individual is performing service in the uniformed services while on active duty for a period of more

PMTA : 02038

than 30 days, and (2) represents all or a portion of the wages the individual would have received from the employer if the individual were performing service for the employer. The amount of differential wage payments that may be taken into account is limited to \$20,000 per employee, resulting in a maximum credit of \$4,000 per employee. An employee is qualified if he has been an employee of the taxpayer for the 91-day period immediately preceding the period for which differential wage payments are made. An employer is eligible if it employed an average of less than 50 employees on business days during the taxable year and provides differential wage payments under a written plan to every qualified employee.

Section 45P(c) provides a rule to coordinate the section 45P credit with other credits that take employee compensation into account when they are calculated. Under this rule, the amount of any such credit determined with respect to compensation of an employee must be reduced by the amount of the section 45P credit determined with respect to that employee if (1) compensation incurred in the current year is an expense used directly in determining the amount of the credit; (2) military differential wage payments are a type of compensation that can be taken into account in determining the amount of the credit; and (3) the military differential wage payments taken into account in determining the employer's section 45P credit are also taken into account in determining the other credit.

With respect to the first prong, section 45P(c) refers to the amount of credit otherwise allowable under this chapter "with respect to compensation paid to any employee." Given that section 45P itself is available only for payments made to employees for the taxable year, we believe that phrase is best understood as applying

where a credit takes into account direct expenses for compensation and not compensation expenses that have been capitalized. We note also that it would be very difficult to administer the offset if it applied where a credit could be based on a capitalized expense for military differential pay as many taxpayers may be unable to trace expenses that were capitalized to determine whether and to what extent they included military differential pay.

With respect to the second prong, a number of other credits that take employee compensation into account in their calculation provide a specific definition of wages to be used. For example, the work opportunity tax credit under section 51 takes account of wages as defined under section 3306(b). Although new section 3401(h) treats military differential pay as wages for purposes of income tax withholding, military differential pay is not considered wages for purposes of FUTA under section 3306 nor for purposes of FICA under section 3121. See Rev. Rul. 69-136, 1969-1 C.B. 252. Therefore, the section 45P credit does not offset the work opportunity tax credit or other credits like it that rely upon the definition of wages for FUTA purposes.

With respect to the third prong, we have identified circumstances where it is possible that military differential pay could be taken into account for purposes of both the section 45P credit, and another credit, such as the research credit or the orphan drug credit, resulting in an offset. For example, under section 41, the research credit is based on qualified research expenses. Qualified research expenses are defined under section 41(b)(2)(A)(i) to include "any wages paid or incurred to an employee for qualified services performed by such employee." Section 41(b)(2)(D)(i) further provides that the "term wages has the meaning given such term by section 3401(a)." As noted above,

pursuant to section 3402(h), military differential pay is considered wages for purposes of section 3401(a). Moreover, for employment tax purposes generally, wages include amounts paid in consideration for the establishment and maintenance of the employment relationship. Within that scope, wages include payments for services that have yet to be performed, services performed contemporaneously with the payment of wages and services that have already been performed. Cf. Rev. Rul. 2004-109, Rev. Rul. 2004-110. Thus, although military differential pay is paid at a time when the employee is not actively performing services for the employer, it would still be considered "wages paid or incurred to an employee for qualified services performed for such employee."

erSection 45P applies to amounts paid after June 17, 2008, the date of enactment of the HEART Act. The section 45P credit is computed with respect to differential wage payments as defined in section 3401(h)(2). Because section 3401(h) is effective for years beginning after December 31, 2008, no 45P credit is allowed with respect to payments made prior to January 1, 2009.